

Asset Class Returns

March 31, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
Bonds (%)					
One-year	1.9	4.0	5.2	3.7	0.4
Five-year	4.2	4.0	5.2	4.8	1.8
Intermediate	-0.7	12.9	9.5	6.9	1.7
Long-term	-12.1	22.5	9.2	7.4	0.9
U.S. stocks (%)					
Large Market	26.5	-37.0	5.4	-1.0	5.4
Large Value	30.2	-40.8	-2.8	4.4	9.8
Small Market	36.3	-36.0	-3.1	5.7	10.0
Small Micro	28.1	-36.7	-5.2	6.3	9.5
Small Value	33.6	-36.8	-10.8	9.1	11.9
Real Estate	28.2	-37.4	-18.7	10.5	10.2
International stocks (%)					
Large Market	30.6	-41.4	12.5	1.4	1.5
Large Value	39.5	-46.3	10.2	6.7	2.0
Small Market	42.0	-43.9	5.6	8.7	5.3
Small Value	39.5	-41.7	3.0	11.3	5.0
Emerg. Mkts.	71.8	-49.2	36.0	9.5	3.6

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Five-Year bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term U.S. Treas.
U.S. Large Market	DFA U.S. Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA U.S. Micro Cap fund
U.S. Small Market	DFA U.S. Small Cap fund
U.S. Small Value	DFA U.S. Small Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Large Cap Int'l fund
Int'l Large Value	DFA Int'l Value fund
Int'l Small Market	DFA Int'l Small Company fund
Int'l Small Value	DFA Int'l Small Cap Value fund
Emerging Markets	DFA Emerging Markets fund

Last 10 yrs. returns are ended 12/31/08.

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The Big Lie

Jeff Troutner, Equius Partners

Is anyone impressed with the “financial reform” charade going on in Washington? I’m not. Wall Street owns Washington and, besides, they’re missing the point. Sure, there are structural issues with the big banks and investment firms that must be addressed: capital requirements, leverage, and proprietary trading among them. But if Congress really wanted to do something productive they could shrink the size and influence of Wall Street overnight. All they need to do is deal with *The Big Lie*.

Equius clients know what The Big Lie is. They learn about it in our first meeting (some know it coming in, but need confirmation and help in avoiding being victimized by it again). The Big Lie is powerful. It dominates our industry. It’s conventional. It unnecessarily has redistributed trillions of dollars of client wealth to Wall Street and its facilitators for over 40 years. Washington allows The Big Lie to continue to be told, and the financial press perpetuates The Big Lie as a reward for some of Wall Street’s profits (advertising dollars).

So what is The Big Lie?

Active management is investing, not speculating.

Active management, in this context, is the method of stock picking, market timing, tactical asset allocation using alternative investments, and other ever-changing strategies used by most mutual funds, money managers, financial planners, and hedge funds in their attempts to “beat the market.” It *does not* describe the active management principles of Benjamin Graham (the recognized “father” of active management) or his most famous student, Warren Buffett. But more on that later.

According to the best research on the subject, active management strategies on the whole have about a 75% failure rate (or about a 1 in 4 chance of success), using mutual funds as an active management proxy.¹ How can those odds represent anything *but* speculation?

Should we be surprised by these odds when, in fact, active management is by definition simply a series of speculative decisions strung together and called “investing”? Will Apple beat Microsoft over the next twelve months? Will interest rates, oil, or gold rise or fall? Will technology stocks outperform consumer durables? Is the market poised for a short-term rally or is it due for a correction? Should we add commodities, hedge funds, or real es-

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tate to the portfolio now? Should we have more or less in the U.S. or emerging markets? Should we “invest” more in China or India?

The odds become even slimmer when you consider that the 25% of actively managed mutual funds that *do* outperform the market is ever-changing. This brings investor behavior into the equation. Consider active management as a big merry-go-round with flashing lights and lots of pretty horses. After riding one pretty horse for a while, investors jump off and ride another one, then another one, and so on until it's no fun anymore. The biggest difference between a real merry-go-round and active management is that you're likely to still have your shirt after riding the former.

So you might be asking yourself, why hasn't a stock broker, financial planner, or investment advisor ever told me that before now? Why doesn't the government *require* them to tell me that?

Well, I have my theories and they all point to power, money, and serious momentum on Wall Street—all pretty hard to overcome for the average person. But the current financial reform effort and a little article buried on page C9 of the April 22 edition of *The Wall Street Journal* provide a little flicker of hope.

Three college professors released a *new* study showing that mutual fund advertising is misleading because the past performance of actively managed mutual funds is due mostly to luck. (Imagine that.) Chris Dodd (the senator from Connecticut who was instrumental in the massive failures of Fannie Mae and Freddie Mac) is “studying” the issue as part of the new financial reforms. Unfortunately, the Investment Company Institute, a tentacle of Wall Street and a rabid protector of The Big Lie, believes that mutual funds are already the “most regulated and transparent products available.” Uh oh, there goes the flicker of hope.

If you have any doubt about the veracity of The Big Lie, you are new to investing, you haven't been burned yet (or enough), or you're just skeptical about how something with a low success rate can remain *the* conventional approach to “investing.” Maybe a little background and a brief history lesson will help.

The Roots of Active Management

As the industrial revolution in the U.S. steamed ahead at the beginning of the last century, vast amounts of new capital were needed to fuel the engine of growth. The financial firms on and around Wall Street in New York City facilitated this capital flow through the creation, issuance, and trading of new securities. Most of the capital at that time came from wealthy individuals and institutions. This was essentially the birth of “active” investing: the process of analyzing individual

stocks, industries, sectors, economic and interest rate forecasts, and other things in order to make bets that, over time, would reward investors for taking risk.

The first solid foundation for this approach goes back to the 1930s with the publishing of Ben Graham and David Dodd's *Security Analysis*, the “bible” of active management. Back then financial markets were not efficient and opportunities to exploit the inefficiencies through more thorough analysis were abundantly available. So individuals who followed the structure and wisdom of Graham's teaching and were willing to put in the time and effort would be rewarded for risk taken. This approach became the conventional method of investing for the long term. One of Graham's students at Columbia University, Warren Buffett, has used this knowledge pretty effectively for many decades.

So what happened to Graham's approach to investing over the years that has resulted in the 75% failure rate of active investing today? A number of things. First, consider how Warren Buffett invests compared to virtually everyone else who picks individual stocks. He tends to *buy and hold* for the long term. He doesn't trade in and out of stocks or try to time the market. Most important, he isn't influenced by Wall Street's opinions or recommendations.

For much of Wall Street's history, a huge part of its firms' profits came from the commissions they earned on stock and bond trades. So naturally, the more trading they encouraged, the bigger their profits. By building stories around the “winners” and “losers” in this stock market derby, the financial press sold newspapers and magazines and publishers like Value Line prospered. The symbiotic relationship of Wall Street and the media grew to the proportions it has today. Frankly, neither could probably survive long without the other.

Things changed dramatically for Wall Street 35 years ago. On May 1, 1975, fixed commissions on stock trades were eliminated. Wall Street firms were faced with either radically changing their business models or risking loss of more and more business to the new “discount brokers” (like Charles Schwab & Co.). This meant that rather than just taking buy and sell orders *from* their customers at very low commission rates, they needed to *sell* additional products and services to justify higher fees and protect their profits.

Remember the limited partnerships in everything from apartment complexes to tuna boats in the early '80s? That didn't work out so well for investors. So Wall Street went back to selling “advice” through its stock brokers, who changed their titles from “Registered Representatives” to “Financial Consultants.” Unfortunately for their customers, they were never forced by the regulatory gods to become legal fiduciaries like

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Equius and other SEC-registered advisors. This allows them to put *their* interests and those of their companies ahead of their investors'.²

The most damaging effect of all this for the average investor is that individual stock and bond *investing* gradually morphed into short-term *speculation*. As I pointed out earlier, the dominant approach to investing is to string a series of short-term speculative bets together and call it a long-term investment strategy. The result is that the average holding period for stocks traded on the New York Stock Exchange today is six months.³ In 1940, it was ten years. Between 1945 and 1965, the average mutual fund had portfolio turnover of 17%. It's now well north of 100%. This translates into funds holding stocks for only eleven months on average instead of six years.⁴

The Turning Point

Probably the biggest hit to the credibility of active management occurred around 1960 when the Center for Research in Securities Prices (CRSP) was founded at the University of Chicago. Computer technology was expanding rapidly, giving academics a powerful tool to research security prices and the performance of active management in new and more elaborate ways. Computers also facilitated the rapid and broad dissemination of financial data, information, and news. What researchers found was that it was becoming increasingly more difficult for previously successful active managers to continue to beat the market through elaborate securities analysis techniques (Graham publicly acknowledged this just prior to his death in 1976). In other words, they concluded that the market is highly efficient in setting securities prices and most active managers were failing miserably in their attempts to outperform it.

The Big Lie was revealed. This was the birth of indexing and the *rebirth* of long-term investing.

The Next Level

The asset class investing strategy that Equius employs takes indexing a giant step further. Based on new research on capital markets published in 1992, asset class investing recognizes that small company and low-priced "value" stocks have their own unique risk and return characteristics, which are independent of the overall market.⁵ Since indexes (such as the S&P 500 and Total Stock Market used by Vanguard and most ETFs) are dominated by very large and high-priced "growth" stocks, an asset class strategy that includes higher percentages of riskier small-company and value stocks is expected to generate a higher return over time.

Based on how much additional small-company and value exposure you include, the increased expected *portfolio* return can be 2% or more per year. Also, because

these additional risk dimensions are independent of one another and the overall market, these risks tend to cancel each other out to some degree in a diversified portfolio. In other words, you can capture the higher weighted-average expected returns of small cap and value stocks with less than a weighted-average of their risk using highly structured and passively managed asset class funds. By the way, this is the elusive "extra return" above the market that active managers strive so hard for and fail so miserably at achieving.

Simple, Liquid, and Transparent

Besides consistently failing in its most basic mission, active management is often plagued by complexity, illiquidity, and lack of transparency. This was most tragically illustrated recently with the Madoff affair but also led to severe losses at the Harvard and Yale endowment funds. In contrast, Robert Maynard has employed a simple, transparent, and focused asset class strategy very successfully over the last twenty years at the Idaho Public Employees Retirement. A review of the performance of the pension fund for the almost thirty years (1965-1992) prior to his tenure is a very clear window into the risks and extremely high costs of active management.⁶

Indexing and asset class investing have been shown time and time again to place the odds of success squarely in favor of investors, not Wall Street and its minions. Active management—judged on the basis of its lack of success versus a low-cost, passive approach—has been a losing strategy for the vast majority of investors for the past forty years.

Active management should be relegated to the speculative realm in which it belongs, either through stricter government "truth in labeling" laws or through a better educated investing public. This would reduce the stature of and demand for active management among serious, long-term investors and reduce the profits of Wall Street and the mutual fund industry that survive and thrive on The Big Lie.

¹ Standard & Poor's Indices Versus Active Funds Scorecard. Mutual fund performance is a very good proxy for all active management because, among other things, mutual funds are public, transparent, and have audited track records.

² After 73 Years: The Last Gasp of the Broker-Dealer, *The Financial Times*, September 15, 2008

³ You're an INVESTOR? How Quaint, Henry Blodget, *Business Insider*, August 8, 2009

⁴ The Mutual Fund Industry 60 Years Later: For Better or Worse?, John Bogle, *Financial Analysts Journal*, January/February 2005.

⁵ The Cross-Section of Expected Returns, *The Journal of Finance*, June 1992.

⁶ Back to the Future: Conventional Investing in a Complex World, Simple, Transparent, and Focused, Robert M. Maynard, CIO, Idaho PERS.

Should You Convert?

This year for the first time investors are able to convert traditional IRA accounts into Roth IRA accounts. On the surface this seems like a no-brainer: Pay income taxes today on the tax-deferred balances in traditional IRAs in anticipation of higher tax rates down the road. But despite what simplistic online calculators might suggest, this is not a simple decision for a lot of investors.

The decision on whether you should convert part or all of your traditional IRA to a Roth IRA is based on a number of complicated and unpredictable variables—which often makes Roth conversions nothing more than an educated guess.

If tax rates or your taxable income rise considerably in the future, a Roth conversion may make sense. Also, if your goal is to leave your IRA assets to the next generation or if you are certain that you will not require income from your IRA during your lifetime, a Roth conversion might make sense. In any case, you would need to have enough money in the bank to cover the only thing that is certain in this process—the taxes you will owe upon conversion.

Ultimately the decision depends on your personal situation and should not be made without the guidance of a qualified CPA. As always, we stand committed to working with you and your accountant to implement whatever decisions are deemed appropriate.

Malkiel Goes Off the Rails

Financial Advisor Magazine ran an article in its April issue titled, “Malkiel On China.” The subtitle is “Burton Malkiel, the Princeton University economist and venerable indexer, is deviating from passive investing in an attempt to get the best returns in China.”

It’s stunning to read the article and observe another seemingly rational investment expert go absolutely gaga over China. Malkiel gushes about the past economic growth of China and then offers reasons why the numbers can’t be trusted. Undeterred, he states, “But even if one doesn’t completely trust the numbers, visiting Shanghai every year tells you that something quite real is happening.”

What’s really happening is that Prof. Malkiel works as the chief investment officer of a Chinese advisory firm, AlphaShares, when he’s not teaching at Princeton. The firm, according to the article, has also developed a unique set of private, *actively managed* funds as well. Oh, now we get it.

How *Not* to Prevent the Next Financial Crisis

Let’s get disgraced politician Rod Blagojevich together with Ponzi schemers Bernie Madoff and Allen Stanford in closed-door sessions to draft new legislation that will create more government agencies to craft even more regulations ostensibly designed to better protect American investors.

While we’re at it, let’s give Blago the authority to lend billions of our dollars to Madoff and Stanford at 0% interest rates so that they can loan it back to us at 3%. This will allow them to continue to make billions in profit while they continue to fleece us, the taxpayers. Sound familiar? Yep, that’s pretty much what’s going on in Washington today. The wolves are meeting to discuss how to protect the sheep.

Government Wolf

As Fannie Mae and Freddie Mac continue to bleed and soak up our tax dollars (about \$400 billion and counting), the people in Congress who fought legislation to rein them in in 2005 are now in charge of “reforming” Wall Street. These are the same people who crucified Alan Greenspan for the Fed’s easy money policy after the first market crash and pilloried him for his belief in free markets. Today, the same Fed policy continues unabated. And as these public servants rail against big banks, they conspire behind closed doors to institutionalize “too big to fail.”

Wall Street Wolf

Wall Street has contributed millions of dollars to these politicians over the years, has placed many of its top executives in key positions in this and the prior administration, has hired lobbying firms who routinely hire former politicians to protect its interests, and is now reporting record quarterly profits after we bailed it out.

We’re probably stuck with the Government Wolf forever. Government never decreases in size and government officials are seldom, if ever, held accountable for their decisions—except at the ballot box. Big deal. We throw the bums out just to see them replaced by other bums. Then the prior bums get cushy jobs on Wall Street or at other corporations and special interest groups whose bidding they did while in office.
